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Agriculture and the 2008 Credit Crisis

Impacts of Tighter Credit in Agriculture

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The availability of credit is a critical factor in agricultural production. Because of the turbulence in the financial markets during the third and fourth quarters of 2008, no one can be certain where we are headed. The government bailout plan may allow credit to flow once again, but we are still in a recession. The question is how long and how severe will the recession be. One thing is certain: Credit markets will be tighter in the foreseeable future. Even if the economy were to recover quickly, the experience of several years of relaxed credit standards, minimal equity requirements, and weakly backed securities will affect lending attitudes throughout the financial markets. Agriculture may not be hit as hard as other sectors, but it will not be insulated from general market conditions.

Credit Markets

In this environment, it is important for borrowers to understand the sources of credit and the nature of credit markets. One way to understand financial and credit markets is to realize that liquidity is the underlying product being bought and sold. Liquidity is the relative availability of useable cash or capital.

So who has excess cash? Well…nobody, but some people have excess liquidity, meaning they don't necessarily need to use all the cash they have today.

A middle-aged person may have sizeable retirement savings, but no plans to use the money for 20 years. A young person may want to buy a home but not have the cash today to make the purchase. In its simplest form, a credit market could involve these two people getting together and making a trade. Credit markets are usually more complicated, however.

Of course it would not be easy for these two people to find and/or trust one another, so banking institutions provide, in a sense, a match-making service. A bank is a clearinghouse that packages capital from many sources and sells it as credit, much like a grocery store offers food from many sources to customers at a retail location.

Supply of Capital (Liquidity)

Whether you call it capital or liquidity, it is supplied by people who have cash but do not need it immediately. When two people trade financial assets it is not always clear who is the buyer and who is the seller. But for this example we will describe the depositor or investor as one selling his liquidity. From the simplest bank deposit to a complicated commercial bond, a person who supplies

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liquid capital essentially sells cash for an asset with less liquidity (cash is more liquid than any other asset). How much less depends on the exact arrangement. We refer to putting money "into" a certificate of deposit (CD) or purchasing a bond, but we could also say that a person sells his cash in return for a written obligation (CD or bond) from a bank or a business to return the money, plus interest, at a later date. The interest is the rental price for using the liquid nature of the cash investment. In general, the more liquidity a person sells in this transaction, the more he is compensated. Interest accrues over time, so foregoing cash for a longer period will generally earn a higher total return. In some cases the written obligation carries some risk, whether in the actual terms or in the reputation of the grantor, in which case the buyer pays the seller a higher rate of return (price) for the use of the capital.

In early fall 2008, the value of many return obligations tied to real estate became so questionable that no one was willing to supply liquid capital to the market.

Demand for Capital (Liquidity)

On the other side of the transaction are those who purchase liquidity. We do not often think of a bank deposit as giving someone else our money to use. But in fact, the bank is in the business of taking deposits from some and letting others use the money to buy cars or houses, start new businesses, etc. A person who takes out a loan is essentially purchasing liquid capital, and the price they pay is the interest on the loan as the principal is repaid over time. In this case the bank makes a profit by selling the liquidity for more than it paid to the depositor. The bank earns its profit by providing a secure and trustworthy clearinghouse where people can trade the use of capital.

Demand for Credit in Production Agriculture

Production agriculture is a capital-intensive business, which means it must have access to credit. Producers must borrow money to purchase land, equipment, breeding livestock and other items, or to invest in new technology. They also need annual operating loans to cover the cost of production each year.

With the current credit crisis, it will be much more difficult for farmers and ranchers to get the loans they need. The most immediate effect will be on operating lines of credit for 2009 production. Most longer term capital needs are not as urgent and usually can be delayed in a tight credit market. Operating loans, however, are critical to annual production and staying in business. If you do not have the money and can not borrow the money for fuel, seed and fertilizer, then you can not put a crop in the ground. Farmers and ranchers may also need short-term credit to finance carry-over notes from unprofitable past production seasons. Some marketing strategies also require borrowed capital to hold hedge positions or to purchase positions in commodity options. Over a longer period of time, the lack of available credit could affect the demand for land and equipment and health of the economy in general.

Sources of Agricultural Credit

Producers generally seek credit from small independent banks, larger holding company banks, the cooperative farm credit system, government agencies, and other business-related or captive financing sources. These types of institutions will feel the effect of a tight credit market in various degrees.

Banks

In the short run, the small, rural, independent bank may be the least affected and the most prepared to continue business as usual. A bank that relies primarily on local deposits and savings to fund loans should see little change in its access to capital. In the long term, however, the small bank will have to compete for those deposits and pay market rates to maintain the same level of capital available for loans.

Larger, holding company banks typically have a solid base of deposits to loan, but they also depend heavily on the secondary markets, from which they acquire capital and to which they sell loan assets. For any size bank, matching the maturity of deposits and loans is important, and secondary financial markets can provide that service. For example, when a bank writes a 30-year, fixed-rate loan, it can not match the loan with a fixed-rate deposit for that length of time. A solution is to obtain long-term capital through bonds or to sell the loan to another institution. When access to these secondary financial markets is limited, a bank's retail lending practices may be affected severely.

Farm Credit System

The Farm Credit System is the largest agricultural lending institution in the country. It is a network of borrower-owned cooperatives that provide credit for agriculture. Unlike a bank, the Farm Credit System does not take deposits, so the system's primary source of capital is the offering of bonds in the bond market. Because the Farm Credit System is a government-sponsored entity (GSE), investors have considered Farm Credit System bonds to be safe investments, but with the failures of Fannie Mae and Freddie Mac (also GSEs), those investors may become leery. Furthermore, the explicit federal guarantee of Fannie and Freddie debt securities and private sector commercial paper has unintentionally distorted the market by making it more difficult for the Farm Credit System to acquire funds because its commercial paper does not carry the same explicit guarantee. The result may be that fewer people invest in Farm Credit System bonds unless the returns are higher. This could make less money available for loans to farmers and ranchers and could result in the rationing of credit and/or in higher interest rates paid for loans.

Government Agency Loans

The United States Department of Agriculture (USDA), through the Farm Service Agency (FSA), also lends directly to farmers and ranchers. Generally considered the "lender of last resort," this government lending program has historically ensured the availability of credit for the production of the nation's food and fiber. In addition to making direct loans, the FSA also underwrites or provides guarantees for agricultural loans made by private sector lenders such as commercial banks and the Farm Credit System. If you use FSA financing, it is important to know that the lending process takes considerably more time than private sector lending, so start early. While FSA funding is not directly reduced by a credit market freeze, it is safe to assume that there will be more demand for FSA loans and loan guarantees as other credit sources disappear and requirements for borrowers increase.

Captive Financing

Another source of capital for production agriculture is captive financing. Captive financing is the extending of credit that is tied to another business transaction or contract. For example, tractor and equipment dealers often provide financing to buyers. In other cases, a commodity buyer may offer a contract that includes the financing of some of the producer's production costs. These sources of capital depend on a company's ability to obtain capital in bond and equity markets, so they may also be restricted when the financial markets are in turmoil.

Credit Outlook

On a positive note, credit standards in agriculture did not slip as far as those in the general home mortgage arena. It would seem that agriculture learned (and remembered) its lesson from the early 1980s, when the bottom fell out from under an industry that had levered up on inflated land values. For now, farm profits and repayment capacity are still strong. This may give agriculture some insulation, but it will not completely protect the industry from a reduction in loanable funds. Add the natural tendency for stricter lending requirements following a financial crisis that many blame on relaxed credit standards, and lenders are likely to respond by rationing credit to the most qualified borrowers.

So what are farmers and ranchers to do in the face of a potential credit squeeze for 2009? There are several bits of sound advice for the coming year, and any time.

First, it is important to understand that for reasons beyond the farmer-lender relationship, your lender may be forced to limit loans. Planning ahead and staying ahead of your financial needs will improve your relationship with your lender. It is also important to talk with your lender sooner rather than later about your 2009 credit needs. If credit is limited, you want to get to the front of the line, be prepared, and make sure your lender knows you are prepared.

It would also be wise to consider other ways to create liquidity within your operation. If possible, restructure debt to extend payments and create liquidity. Look for non-bank sources of credit to reduce the amount you need for an operating loan. Where possible, you might consider non-traditional business models or partnerships that create liquidity. While it should not be the driving force in production decisions, you should consider the liquidity needs of various production plans. Changing tenure arrangements with landlords may also reduce the need for credit. The important factor is to plan ahead and consider your options while you still control your options.

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